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S E C R E T SECTION 01 OF 03 ISLAMABAD 000326

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TAGS: [ECON](#) [EFIN](#) [PGOV](#) [PREL](#) [PTER](#) [CH](#) [PK](#)

SUBJECT: SCENE SETTER FOR DEPUTY SECRETARY OF THE TREASURY  
NEAL WOLIN

Classified By: Ambassador Anne W. Patterson for reasons 1.4 (b) and (d)

11. Summary: (C) Deputy Secretary Wolin's visit to Pakistan comes at a time when Pakistan's long term stability depends more and more upon the government's willingness to confront difficult economic policy choices it has long sought to avoid. Pakistan must begin to address a breadth of economic challenges that would overwhelm many emerging economies: overhauling the tax infrastructure, eliminating over \$4 billion in circular debt in its energy sector, altering revenue sharing agreements among the provinces and the Federal Government, reversing a contraction in consumer credit and expanding financial access, removing price controls in commodity markets, preventing a crisis in water distribution, and breaking Pakistan's dependence on external financial support.

12. (C) At the same time, Pakistan must also finance an increasingly expensive and difficult war along its Afghan border, and provide humanitarian relief to those displaced by the conflict. These security expenditures alone will make it difficult for Pakistan to meet its fiscal deficit target of 4.9 percent of GDP, without the demands economic reforms will put on the budget. This will make the upcoming review of the IMF stand-by-arrangement, which begin in Dubai the week you arrive, the most difficult yet. End Summary.

Shaukat Tarin, Successful, but Exhausted

13. (S) Since the balance-of-payments crisis in the Fall of 2008, staying on track with the IMF program has been an exhausting, but essential, struggle for Pakistani policy makers, particularly Finance Minister Shaukat Tarin. Tarin has fought the cabinet on tax reform, revenue sharing, and most fiercely on energy policy. Some initial objectives, such as expanding the tax net to the agriculture sector, have become a lesser priority due to intractable political pressure. However, he has held firm against political pressure when phasing out of subsidies and adjusting administered energy prices. Tarin can also point to successes in the economy as he leaves office: electricity tariffs are increasing, large scale manufacturing has shown modest improvement, portions of the agricultural sector are showing life, and international remittances broke records in the first half of the year. However, keeping the economy

relatively stable and keeping the IMF program on track, all with little support from his fellow cabinet members, has left Tarin exhausted and besieged.

#### The Unhealthy Equilibrium Between Tax Collector and Businessman

¶4. (C) Pakistan's Tax Administration and Enforcement Agency, the Federal Board of Revenue (FBR), is arguably Shaukat Tarin's greatest administrative challenge. In the opinion of several international donors, and the FBR's Chairman, the organization is inefficient, corrupt, and widely unpopular among the one percent of the population that file tax returns. Pakistan's tax-to-GDP ratio hovers at an anemic 8.8 percent, and corruption and bureaucratic infighting plague the FBR, hampering its efficiency. Further, tax exemptions are very high in Pakistan. Although some concessions or exemptions can be rationally justified, pressures from vested interest group and strong corporate lobbies leave lower level tax officials intimidated. Local tax officials admit to receiving political pressure even when they try to tax small businesses and shop keepers. Unions and Associations of lawyers, doctors, and caterers also lobby politicians to escape the tax net. Illustrating this problem, the service sector contributes 50% of GDP, but contributes only 16.5 percent of taxes.

¶5. (C) It is not just political pressure that hampers tax collection, governance and corruption problems within the FBR are just as damaging. Echoing many of the concerns of the

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Finance Minister, and the business community, the UK's Department for International Development (DFID) and the World Bank have identified a culture of graft and abuse in the FBR.

The natural response among legitimate business owners and individual tax payers is to simply avoid the tax system altogether. The IMF program, and its tough deficit targets, contributes to the business community's anxiety. Given the narrow tax base, businesses complain the FBR is auditing them several times a year and withholding refunds in order for the GOP to meet its revenue targets.

Salim Raza's Monetary Policy: On the Right Track, but Patience and Time Required

¶6. (S) Salim Raza recently completed his first year as Governor of the State Bank of Pakistan (SBP), having replaced the extremely capable, technocratic, and popular (at least with the international donor community) Dr. Shamshad Akhtar. Before departing office in December 2008, Akhtar raised the policy rate 200 basis points to 15 percent in an effort to bring down an inflation level that had reached 24 percent. Akhtar often fought against a Finance Ministry (before Tarin's arrival) that failed to resist policy decisions that helped lead to the balance-of-payments crisis. However, Akhtar's decision was a critical indicator to the donor community, and the IMF, that Pakistan could make difficult decisions in order to stabilize its economy. When Akhtar left her post, there was some suspicion within the international community about her successor, Salim Raza, and his ability to act independently, given his close relationship with President Zardari. Since taking the helm, however, Raza has been a relatively successful central banker, helping to bring down inflation from its high of 24.4 percent in late 2008, to its current level of 10.3 percent.

¶7. (C) Considering that the State Bank of Pakistan has remained highly biased towards managing inflationary expectations rather than in minimizing the growing output gap, it is likely that Raza will retain a conservative stance until the end of the Pakistani fiscal year on June 30. Even before their monetary statement on January 30, State Bank officials have been citing inflationary pressures associated with increasing commodity prices and increasing demand in building materials. With a double digit policy rate, the

business community has been unsurprisingly vocal in wanting quicker and sharper policy rate cuts. Raza, however, does not admit to feeling political pressure for his policy rate decisions. Moreover, his monetary policy is welcomed among most of the CEO's of Pakistan's leading commercial banks. Despite the contraction of consumer credit, bankers want to lend money. However, they are concerned that if inflation rebounds, it will impact on the high amount of government paper on their balance sheets.

#### Energy and the Circular Debt

18. (SBU) Following a joint Asian Development Bank-World Bank Plan, blessed by the IMF, the GOP took responsibility for \$4 billion of intra-corporate bank debt from the state-owned energy sector. Under the plan, the debt was to be removed from the books of power sector firms and placed in a debt holding company. The transfer of funds has yet to occur, though the Ministry of Finance has taken over the debt servicing. The transfer has been hampered by Ministry of Finance bureaucratic inefficiencies as well as the hesitancy of commercial banks to move their loans to a holding company with zero assets. Though payment terms are low this fiscal year, they will exceed \$1.2 billion in years FY 11, 12, and FY 13. The GOP has yet to come up with a plan to extend the repayment period or lower debt-servicing costs.

19. (SBU) Following the ADB/WB plan, the GOP has raised power tariffs by a 6 percent increase planned for April 1. However, this has not been sufficient to close the gap between costs and collections. Since September 2009, \$1 billion of new debt has accrued on the books of the

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state-owned energy sector players; \$300 to \$400 million of this could be collected from provincial governments that have yet to pay their bills, the rest will fall squarely on the GOP to cover. Currently, nearly the entire power sector is controlled by PEPCO, a GOP holding company. Until the sector is restructured, with state-owned distribution and generation companies, there is little hope that the sector will turn around. Tariff increases, without improvement in management and collection, stand little chance of ending the accrual of arrears in the sector.

#### Combating Terror Finance: Improving, but Hamstrung by Inconsistent Policies

10.(S) In the past year, Pakistan has made steady progress in combating money laundering and the financing of terrorism. Earlier this year, Pakistan's Federal Investigation Agency (FIA) partnered with the State Bank of Pakistan to crack down on large licensed and unlicensed money service businesses that were violating foreign exchange law and contributing to money laundering. Regarding its legal structure, Pakistan is close to passing its first anti-money laundering law. Much of the impetus came from a sternly worded FATF statement in October. Parliament will likely complete passage of the bill before the end of the month. Using its existing Anti-Terrorism Act, Pakistan has brought to book terrorist financiers involved in the November 2008 Mumbai attacks. Of all the suspects, nine are financiers, two of whom are in police custody.

11. (S) These achievement are tempered by the fact the government has not effectively cracked down on financial support received by the Haqqani network, other Taliban groups, and Lashkar-e-Tayiba. Pakistan still blocks attempts by the international community to formally designate certain terrorist groups operating in Pakistan. Despite the success of the FIA in cracking down on illegally operating money service businesses, financial facilitators for extremist group still depend on Pakistan's largely undocumented economy for their anonymity. State Bank of Pakistan officials believe that the ratio of undocumented and documented international remittances into Pakistan is approximately 1/1.

Since reported monthly figures measure \$600 - \$800 per month, the FIA and SBP's plan to continue cracking down on the money service businesses is a Herculean, but worthwhile objective.

#### GOP Behavior Complicates Assistance Relationship

¶12. (S) One of the greatest challenges in providing assistance to Pakistan and pressing for much needed economic reforms is that there are deep suspicions of U.S. motivations across a broad swath of Pakistani society. The military and intelligence establishment in particular view the United States as favoring India over Pakistan, and believe the U.S. opposes Pakistan's nuclear weapons program, considered to be essential for the country's national security. These forces have, at times, interfered with the timely distribution of or access to assistance, or memorandums of understanding. While the Ministry of Finance and the State Bank of Pakistan are willing partners, neither institution, nor indeed the President or Prime Minister, can regularly prevail against these powerful interests.

PATTERSON